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CHAPTER

2 Financial Statements and Accounting Concepts/Principles

CHAPTER OUTLINE:

I. Financial Statements
- A. From Transactions to Financial Statements
- B. Financial Statements Illustrated
  - 1. Explanations and Definitions
    - a. Balance Sheet
    - b. Income Statement
    - c. Statement of Changes in Stockholders' Equity
    - d. Statement of Cash Flows
  - 2. Comparative Statements in Subsequent Years
  - 3. Illustration of Financial Statement Relationships

II. Accounting Concepts and Principles
- A. Schematic Model of Concepts and Principles
- B. Concepts/Principles Related to the Entire Model
- C. Concepts/Principles Related to Transactions
- D. Concepts/Principles Related to Bookkeeping Procedures and the Accounting Process
- E. Concepts/Principles Related to Financial Statements
- F. Limitations of Financial Statements

III. The Corporation's Annual Report

TEACHING/LEARNING OBJECTIVES:

Principal:

1. To illustrate the four principal financial statements and their basic form.

2. To introduce students to the terminology of financial statements.

3. To present the accounting equation.

4. To explain several of the concepts of financial accounting and financial statement presentation.

Supporting:

5. To explain that financial statements are the product of financial accounting and that the statements represent a historical summary of transactions.

6. To explain some of the limitations of financial statements.

7. To illustrate that the financial statements are included in the corporation's annual report.

8. To introduce and explain several business procedures and their terminology.

TEACHING OBSERVATIONS:

1. This is the keystone chapter of the text, and the material presented here becomes a foundation for all subsequent financial accounting topics. **The instructor must resist trying to teach the entire course from this one chapter!** Instead, try to help students sort out the key ideas that must be learned ***now*** from those that they should be acquainted with, but that will really be learned when subsequent material is covered. Items to be learned now include:
   a. What a transaction is.
   b. The name of each financial statement and what it shows.
   c. The accounting equation.
   d. Financial statement relationships.
   e. Limitations of financial statements.

2. A significant amount of time should be spent illustrating and explaining the purpose and content—by account category (asset, liability, stockholders' equity, revenue, expense)—of each financial statement, and how the financial statements tie together. Some instructors may wish to discuss gains and losses at this point, but the key is to keep it as simple as possible!

3. It is recommended that the following models be emphasized:

   a. **Balance Sheet:**

	Assets	=	Liabilities	+	Stockholders' Equity
Beginning of Period	$		$		$
Changes During Period	+/-		+/-		+/-
End of Period	$		$		$

   b. **Income Statement:**

      Revenues
      \- Expenses
      = Net Income

   c. **Statement of Changes in Stockholders' Equity:**

      Beginning Balance of Stockholders' Equity
      \+ Owners' Investment
      \+ Net Income
      \- Dividends
      = Ending Balance of Stockholders' Equity

   (As with the discussion of gains and losses, some instructors may wish to acknowledge "other" sources of changes in stockholders' equity such as treasury stock, accumulated other comprehensive income, prior period adjustments, etc. This is a function of instructor preference and the extent to which students have been previously exposed to real world financial statements. An early dose of "reality" can be refreshing for graduate students, but might be distracting to a younger, less experienced audience.)

4. It is helpful to spend time with the concepts and principles model, explaining what each concept/principle means and showing how it relates to the "Transactions to Financial Statements" process.

5. It is appropriate to emphasize the limitations of financial statements now, because they can create a mindset that helps students understand more specific accounting principles when they are covered later.

6. The Business In Practice boxes are designed to enhance student understanding by removing some jargon and explanation from the flow of the text material, while providing a context for that material. These provide good class discussion topics.

7. You may wish to encourage students to self-study this material by using the PowerPoint presentations available on the website.

8. Remind students that the fully worked-out solutions to all odd-numbered exercises and problems are provided on the website. The student study guide (previously a printed volume that students were required to purchase separately) is also available on the website for free.

ASSIGNMENT OVERVIEW:

This chapter provides a wide variety of assignments to choose from—ranging from the basic association-type mini-exercises and exercises, to the more challenging, analytical-type problems. Be careful not to over-assign or under-assign homework from this chapter.

NO.	LEARNING OBJECTIVES	DIFFICULTY & TIME ESTIMATE	OTHER COMMENTS
M2.1.	2, 3	Easy, 3-5 min.	Similar to E2.9.-E2.14.
M2.2.	2, 3	Easy, 3-5 min.	See M2.1. Good in-class demo exercise.
M2.3.	2, 3	Med., 7-10 min.	Challenging mini-exercise. Requires clear-cut understanding of income statement relationships. *Encourage use of Exhibit 2-2 as a solution model.*
M2.4.	2, 3	Med., 7-10 min.	See M2.3. Good way to review and reinforce the structure of the income statement in class.
M2.5.	2, 4	Easy, 2-3 min.	Basic identification of asset accounts.
M2.6.	2, 4	Easy, 2-3 min.	Basic identification of income statement accounts.
E2.7.	2, 4	Easy, 3-5 min.	Simple account identification exercise.
E2.8.	2, 4	Easy, 3-5 min.	See E2.7.
E2.9.	2, 3	Med., 5-8 min.	Reinforces the balance sheet equation, and stresses the distinction between PIC and RE.
E2.10.	2, 3	Med., 5-8 min.	See E2.9. Good homework assignment.
E2.11.	2, 3	Easy, 3-5 min.	"RE is affected *only* by net income (loss) and dividends." This is a bit of a fiction, but it works effectively in the Chapter 2. Other effects on retained earnings (i.e., stock dividends, certain treasury stock transactions, and prior period adjustments) are not discussed until Chapter 8.
E2.12.	2, 3	Easy, 3-5 min.	See E2.11. Good homework assignment.
E2.13.	2, 3	Med., 5-10 min.	The worksheet format is used to help students understand financial statement relationships. Explain that "net assets" = A-L = SE.
E2.14.	2, 3	Med., 5-10 min.	See E2.13. Good in-class demonstration exercise.
P2.15.	2, 3, 6	Med., 7-10 min.	Most instructors omit this problem. Can be used to illustrate the sale of assets at gains/losses, and to emphasize the difference between cash and stockholders' equity.
P2.16.	2, 3, 6	Med., 10-12 min.	See P2.15.
P2.17.	2, 3, 4	Med., 15-20 min.	Straight-forward problem emphasizing financial statement relationships. Students respond well.
P2.18.	2, 3, 4	Med., 15-20 min.	See P2.17.
P2.19.	2, 3, 4	Med., 20-25 min.	Similar to P2.15., P2.16., but requires the preparation of financial statements. Good for in-class demonstration.
P2.20.	2, 3, 4	Med., 20-25 min.	**Excel problem.** See P2.19. Good homework assignment.
P2.21.	2, 3	Med., 5-8 min.	Can use later as a Chapter 4 assignment.
P2.22.	2, 3, 6	Med.-Hard, 15-20.	**Group learning problem.** Good in-class demonstration problem.
P2.23.	2, 3, 5	Med., 7-10 min.	Stress the importance of the historical cost principle.
P2.24.	2, 3, 5, 6	Med., 10-12 min.	**Group learning problem.** See P2.23.
P2.25.	2, 4	Med., 10-12 min.	**Group learning problem.** Emphasizes the structure of the income statement.
P2.26.	2, 4	Med., 10-12 min.	Explain why "Other Income, net" is excluded from operating income.
C2.27.	2, 4, 6, 7	Med., 15-20 min.	Excellent conceptual case, but be sure to relate student responses back to the terminology introduced in the chapter.

SOLUTIONS:

M2.1.

	A	**=**	**L**	**+**	**SE**
Beginning:	$96,000	=	$54,000	+	?
Changes:		=			+16,000 net income (increase to retained earnings)
					-4,000 dividends (decrease to retained earnings)
Ending:		=		+	?

Solution approach:
Beginning stockholders' equity = $96,000 - $54,000 = **$42,000**. Net income increases retained earnings and dividends decrease retained earnings. Retained earnings are part of stockholders' equity, so assuming no other changes occurred during the year, ending stockholders' equity = $42,000 + $16,000 - $4,000 = **$56,000**.

M2.2.

	SE
Beginning:	$164,000
Changes:	+20,000 common stock issued at par value (increase to paid-in capital)
	+24,000 net income (increase to retained earnings)
	-6,000 dividends (decrease to retained earnings)
Ending:	?

Solution approach:
No information is given about assets or liabilities, so the focus is entirely on stockholders' equity. Beginning stockholders' equity +/- changes during the year = ending stockholders' equity. $164,000 + $20,000 + $24,000 - $6,000 = **$202,000.**

M2.3.

Net sales	$250,000	
Cost of goods sold	?	= 150,000
Gross profit	$100,000	
Selling, general, and administrative expenses	44,000	
Income from operations	?	= 56,000
Interest expense	?	= 6,000
Income before taxes	$?	= 50,000
Income tax expense	10,000	
Net income	$ 40,000	

Solution approach:
Set up an income statement using the structure and format as shown in Exhibit 2-2, then solve for missing amounts.

One possible calculation sequence: (1) $250,000 - $100,000 = **$150,000** cost of goods sold. (2) $100,000 - $44,000 = **$56,000** income from operations. (3) $40,000 + $10,000 = **$50,000** income before taxes. (4) $56,000 - $50,000 = **$6,000** interest expense.

M2.4.

Net sales	$?	= 200,000
Cost of goods sold	80,000	
Gross profit	$?	= 120,000
Selling, general, and administrative expenses	44,000	
Income from operations	76,000	
Interest expense	12,000	
Income before taxes	$?	= 64,000
Income tax expense	16,000	
Net income	$?	= 48,000

Solution approach:
Set up an income statement using the structure and format as shown in Exhibit 2-2, then solve for missing amounts.

Calculation sequence: (1) $76,000 - $12,000 = **$64,000** income before taxes. (2) $64,000 - $16,000 = **$48,000** net income. (3) $76,000 + $44,000 = **$120,000** gross profit. (4) $120,000 + $80,000 = **$200,000** net sales.

An alternative calculation sequence would have been to solve for gross profit and net sales first, and to then solve for income before taxes and net income.

M2.5.

Common stock and retained earnings are stockholders' equity accounts; cost of goods sold and interest expense are expenses; sales is a revenue account; long-term debt and accounts payable are liabilities.

The assets listed are: land, merchandise inventory, equipment, accounts receivable, supplies, cash, and buildings.

M2.6.

Sales and service revenues are revenues accounts on the income statement; income tax expense, cost of goods sold, and rent expense are expenses on the income statement.

Land, equipment, accounts receivable, supplies, buildings, and cash are assets on the balance sheet; accumulated depreciation is a contra-asset on the balance sheet; notes payable is a liability on the balance sheet; and common stock is a stockholders' equity account on the balance sheet.

E2.7.

	Category	*Financial Statement(s)*
Cash………………………………………………	**A**	**BS**
Accounts payable……………………………..	**L**	**BS**
Common stock…………………………………	**SE**	**BS**
Depreciation expense…………………………..	**E**	**IS**
Net sales………………………………………..	**R**	**IS**
Income tax expense…………………………….	**E**	**IS**
Short-term investments………………………...	**A**	**BS**
Gain on sale of land…………………………….	**G**	**IS**
Retained earnings………………………………	**SE**	**BS**
Dividends payable……………………………..	**L**	**BS**
Accounts receivable……………………………	**A**	**BS**
Short-term debt…………………………………	**L**	**BS**

E2.8.

	Category	*Financial Statement(s)*
Accumulated depreciation……………………...	**A**	**BS**
Long-term debt…………………………………	**L**	**BS**
Equipment………………………………………	**A**	**BS**
Loss on sale of investments………..………...	**LS**	**IS**
Net income………………………………………	**SE***	**IS**
Merchandise inventory…………………………	**A**	**BS**
Other accrued liabilities…………………………	**L**	**BS**
Dividends paid………………………………….	**SE**	**Neither****
Cost of goods sold………………………………	**E**	**IS**
Additional paid-in capital……………………….	**SE**	**BS**
Interest income………………………………….	**R**	**IS**
Selling expenses………………………………..	**E**	**IS**

* Although net income appears as a caption on the income statement, it represents an increase to retained earnings, which is a stockholders' equity account.

****** Trick question! "Dividends paid" appears only on the Statement of Changes in Stockholders' Equity. Dividends paid are distributions of earnings that reduce retained earnings on the balance sheet. Dividends paid are not expenses, and thus do not appear on the income statement.

E2.9.

Use the accounting equation to solve for the missing information:

Firm A:

A	=	L	+	PIC	+ (Beg. RE	+	NI	-	DIV	=	End. RE)
$210,000	**=**	**$108,000**	**+**	**$37,000**	**+ ($39,000**	**+**	**?**	**-**	**$25,000**	**=**	**?)**

In this case, the ending balance of retained earnings must be determined first:
$210,000 = $108,000 + $37,000 + End. RE
Retained earnings, 12/31/16 = **$65,000**

Once the ending balance of retained earnings is known, net income can be determined:
$39,000 + NI – $25,000 = $65,000
Net income for 2016 = **$51,000**

Firm B:

A	=	L	+	PIC	+ (Beg. RE	+	NI	-	DIV	=	End. RE)
$270,000	**=**	**$72,000**	**+**	**?**	**+ (?**	**+**	**$41,000**	**-**	**$9,000**	**=**	**$155,000)**

$270,000 = $72,000 + PIC + $155,000
Paid-in capital, 12/31/16 = **$43,000**

Beg. RE + $41,000 - $9,000 = $155,000
Retained earnings, 1/1/16 = **$123,000**

Firm C:

A	=	L	+	PIC	+ (Beg. RE	+	NI	-	DIV	=	End. RE)
$162,000	**=**	**?**	**+**	**$20,000**	**+ ($21,000**	**+**	**$56,000**	**-**	**$32,000**	**=**	**?)**

In this case, the ending balance of retained earnings must be determined first:
$21,000 + $56,000 - $32,000 = End. RE
Retained earnings, 12/31/16 = **$45,000**

Once the ending balance of retained earnings is known, liabilities can be determined:
$162,000 = L + $20,000 + $45,000
Total liabilities, 12/31/16 = **$97,000**

E2.10.

Use the accounting equation to solve for the missing information:

Firm A:

A = L + PIC + (Beg. RE + NI - DIV = End. RE)
$? = $80,000 + $55,000 + ($50,000 + 68,000 - $12,000 = ?)

In this case, the ending balance of retained earnings must be determined first:
$50,000 + $68,000 - $12,000 = End. RE
Retained earnings, 12/31/16 = **$106,000**

Once the ending balance of retained earnings is known, total assets can be determined:
A = $80,000 + $55,000 + $106,000
Total assets, 12/31/16 = **$241,000**

Firm B:

A = L + PIC + (Beg. RE + NI - DIV = End. RE)
$435,000 = ? + $59,000 + ($124,000 + $110,000 - ? = $186,000)

$435,000 = L + $59,000 + $186,000
Total liabilities, 12/31/16 = **$190,000**

$124,000 + $110,000 - DIV = $186,000
Dividends declared and paid during 2016 = **$48,000**

Firm C:

A = L + PIC + (Beg. RE + NI - DIV = End. RE)
$155,000 = $75,000 + $45,000 + (? + $25,000 - $16,000 = ?)

In this case, the ending balance of retained earnings must be determined first:
$155,000 = $75,000 + $45,000 + End. RE
Retained earnings, 12/31/16 = **$35,000**

Once the ending balance of retained earnings is known, the beginning balance of retained earnings can be determined:
Beg. RE + $25,000 - $16,000 = $35,000
Retained earnings, 1/1/16 = **$26,000**

E2.11.

Prepare the retained earnings portion of a statement of changes in stockholders' equity for the year ended December 31, 2016:

Retained Earnings, December 31, 2015……………………………………	$ 623,600
Less: Net loss for the year ended December 31, 2016…………………..	(9,400)
Less: Dividends declared and paid in 2016…..………………………….	(37,000)
Retained Earnings, December 31, 2016……………………………………	**$577,200**

E2.12.

Retained Earnings, December 31, 2015……………………………….…	?
Less: Net income for the year ended December 31, 2016………………..	22,600
Less: Dividends declared and paid in 2016…..…………………………..	(4,500)
Retained Earnings, December 31, 2016………………………………….	$210,300

Solving the model, retained earnings at December 31, 2015 was **$192,200.**

E2.13.

					SE				
	A	**=**	**L**	**+**	**PIC**	**+**	**RE**		
Beginning:	$37,200	=	$21,000	+	$ 0	+	**$16,200**		
Changes:	?	=	-3,600	+	0	+	9,000	(net income)	
							?	(dividends)	
Ending:	?	=	?	+	0	+	$18,000		

Solution approach:

*(Remember that **net assets** = Assets - Liabilities = Stockholders' equity = PIC + RE).* Since paid-in capital did not change during the year, assume that the beginning and ending balances are $0. Thus, beginning retained earnings = $37,200 - $21,000 = **$16,200**, and ending retained earnings = net assets at the end of the year = $18,000. By looking at the RE column, it can be seen that dividends must have been **$7,200**. Also by looking at the liabilities column, it can be seen that ending liabilities are **$17,400**, and therefore ending assets must be **$35,400**. Thus, total assets decreased by **$1,800** during the year ($37,200 - $35,400), which is equal to the net decrease on the right-hand side of the balance sheet (-$3,600 liabilities + $9,000 net income - $7,200 dividends = $1,800 net decrease in assets).

E2.14.

						SE			
	A	**=**	**L**	**+**	**PIC**	**+**	**RE**	
Beginning:	?	=	$320,000	+	$ 30,000	+	?	
Changes:	+65,000	=	-18,000	+	?	+	?	(net income or loss)
							-25,000	(dividends)
Ending:	?	=	?	+	$192,000	+	?	($429,000 total SE)

Solution approach:
Ending retained earnings = $429,000 total stockholders' equity - $192,000 paid-in capital = **$237,000.** Ending liabilities = $320,000 beginning liabilities - $18,000 decrease = **$302,000.** Thus, ending assets = $302,000 liabilities + $429,000 stockholders' equity = **$731,000.** Beginning assets = $731,000 ending assets - $65,000 increase = **$666,000.** Beginning retained earnings = $666,000 assets - $320,000 liabilities - $30,000 paid-in capital = **$316,000.** Once the beginning and ending retained earnings balances are known, the net income or loss for the year can be determined as follows:

Retained earnings, beginning.	$316,000
Less: Net income or loss for the year	?
Less: Dividends declared and paid during the year	(25,000)
Retained earnings, ending......	$237,000

Solving the model, the net loss of the year = $(54,000).

P2.15. Set up the accounting equation and show the effects of the transactions described. Since total assets must equal total liabilities and stockholders' equity, the unadjusted stockholders' equity can be calculated by subtracting liabilities from the total of the assets given.

	A							=	L	+	SE
	Cash	+	Accounts Receivable	+	Inventory	+	Plant & Equipment	=	Liabilities	+	Stockholders' Equity
Data given	$ 45,600	+	228,400	+	122,800	+	530,000	=	611,200	+	315,600
Collection of accounts receivable	+216,980		-228,400								-11,420
Inventory liquidation	+98,240				-122,800						-24,560
Sale of plant & equipment	+380,000						-530,000				-150,000
Payment of liabilities	-611,200								-611,200		0
Balance	$ 129,620		0		0		0		0		$ 129,620

*The effects of these transactions on stockholders' equity represent losses from the sale (or collection) of the non-cash assets.

P2.16.

a. The solution approach is similar to that shown in Problem 2-15. Gains or losses can be calculated for the sale (or collection) of each of Kimber Co.'s non-cash assets, as follows:

		Cash received upon sale or collection of asset		***Gain (loss) recorded and effect on Stockholders' Equity***
Accounts receivable	$62,600 * 90% =	$ **56,340**	$62,600 * 10% =	**$ (6,260)**
Merchandise inventory . .	$114,700 * 80% =	**91,760**	$114,700 * 20% =	**(22,940)**
Buildings & Equipment . .	BV^ + $40,000 =	**188,000**	Amount above BV =	**40,000**
Land.	Appraised amount =	**65,000**	$65,000 - $51,000 =	**14,000**
Total cash received		**$401,100**	**Net gain**	**$ 24,800**

^ $343,000 - $195,000 accumulated depreciation = $148,000 book value of buildings & equipment.

The $401,100 cash received from the liquidation of non-cash assets would be added to the beginning cash balance of $18,400, and $419,500 is the amount of cash available to pay the claims of creditors and stockholders. Liabilities would be paid first (including the amounts that are *not* shown on the balance sheet), and the balance would be paid to the stockholders:

Total cash available...		$419,500
Accounts payable	$46,700	
Notes payable	58,500	
Wages payable (not shown on balance sheet)..........	2,400	
Interest payable (not shown on balance sheet)..........	5,100	
Long-term debt..........	64,800	(177,500)
Total cash available to stockholders..........		**$242,000**

The total cash available to stockholders upon liquidation can be verified, as follows:

Total stockholders' equity (*unadjusted*, from balance sheet)	$224,700
Add: Gain on sale of buildings & equipment	40,000
Add: Gain on sale of land	14,000
Less: Loss on collection of accounts receivable	(6,260)
Less: Loss on liquidation of merchandise inventory	(22,940)
Less: Unrecorded wages expense......	(2,400)
Less: Unrecorded interest expense....	(5,100)
Total stockholders' equity, *as adjusted*......	**$242,000**

A summary reconciliation is as follows:

Total stockholders' equity (*unadjusted*, from balance sheet)	$224,700
Add: Net gain from liquidation of all assets *(see calculations above)*….	24,800
Less: Unrecorded liabilities for wages and interest…………………	(7,500)
Total stockholders' equity, *as adjusted*......	**$242,000**

P2.16. ***(continued)***

b. As shown in the schedule in part a), total stockholders' equity on the balance sheet had not been adjusted for the gains and losses from the sale (or collection) of the non-cash assets; nor was it adjusted for the effects of the expense/liability accruals for wages and interest.

P2.17.

a.

Accounts receivable	$ 99,000
Cash	27,000
Supplies	18,000
Merchandise inventory	93,000
Total current assets	**$237,000**

b.

Accounts payable	$ 69,000
Long-term debt	120,000
Common stock	30,000
Retained earnings	177,000
Total liabilities and stockholders' equity	**$396,000**

c.

Sales revenue	$420,000
Cost of goods sold	(270,000)
Gross profit	$150,000
Service revenue	60,000
Depreciation expense	(36,000)
Supplies expense	(42,000)
Earnings from operations (operating income)	**$132,000**

d.

Earnings from operations (operating income)	$132,000
Interest expense	(12,000)
Earnings before taxes	$120,000
Income tax expense	(36,000)
Net income	**$ 84,000**

e. $36,000 income tax expense / $120,000 earnings before taxes = **30% average tax rate**

f.

Retained earnings, January 1, 2016	?
Net income for the year	$ 84,000
Dividends declared and paid during the year	(48,000)
Retained earnings, December 31, 2016	$177,000

Solving the model, the beginning retained earnings balance must have been **$141,000**, because the account balance increased by $36,000 during the year to an ending balance of $177,000.

P2.18.

a.

Merchandise inventory	$ 210,000
Accounts receivable	48,000
Cash	36,000
Total current assets	$ 294,000
Less: Accounts payable *	(23,000)
Current assets less current liabilities	**$ 271,000**

* No other current liabilities are included in the problem.

b.

Total current assets	$ 294,000
Land	32,000
Equipment	18,000
Accumulated depreciation	(6,000)
Total assets	**$ 338,000**

c.

Sales revenue	$ 620,000
Cost of goods sold	(440,000)
Gross profit	$ 180,000
Rent expense	(18,000)
Depreciation expense	(3,000)
Earnings from operations (operating income)	**$ 159,000**

d.

Earnings from operations (operating income)	$ 159,000
Interest expense	(9,000)
Earning before taxes	$ 150,000
Income tax expense	(60,000)
Net income	**$ 90,000**

e. $60,000 income tax expense / $150,000 earnings before taxes = **40% average tax rate**

f.

Retained earnings, January 1, 2016	?
Net income for the year	$ 90,000
Dividends declared and paid during the year	(64,000)
Retained earnings, December 31, 2016	$225,000

Solving the model, the beginning retained earnings balance must have been **$199,000**, because the account balance increased by $26,000 during the year to an ending balance of $225,000.

P2.19.

a.

BREANNA, INC.
Income Statement
For the Year Ended December 31, 2016

Sales	$800,000
Cost of goods sold	(512,000)
Gross profit	$288,000
Selling, general, and administrative expenses	(136,000)
Earnings from operations (operating income)	$152,000
Interest expense	(24,000)
Earnings before taxes	$128,000
Income tax expense	(32,000)
Net income	$ 96,000

BREANNA, INC.
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 2016

Paid-in capital:		
Common stock		$360,000
Retained earnings:		
Beginning balance	$ 92,000	
Net income for the year	96,000	
Less: Dividends declared and paid during the year	(48,000)	
Ending balance		140,000
Total stockholders' equity		$500,000

BREANNA, INC.
Balance Sheet
December 31, 2016

Assets:		
Cash	$260,000	
Accounts receivable	40,000	
Merchandise inventory	148,000	
Total current assets		$448,000
Equipment	480,000	
Less: Accumulated depreciation	(208,000)	272,000
Total assets		$720,000
Liabilities:		
Accounts payable	$ 60,000	
Long-term debt	160,000	
Total liabilities		$220,000
Stockholders' Equity:		
Common stock	$360,000	
Retained earnings	140,000	
Total stockholders' equity		$500,000
Total liabilities and stockholders' equity		$720,000

P2.19. ***(continued)***

b. $32,000 income tax expense / $128,000 earnings before taxes = **25% average tax rate.**

c. $24,000 interest expense / $160,000 long-term debt = **15% interest rate.** This assumes that the year-end balance of long-term debt is representative of the *average* long-term debt account balance throughout the year.

d. $360,000 common stock / 36,000 shares = **$10 per share par value.**

e. $48,000 dividends declared and paid / $96,000 net income = **50%**. This assumes that the board of directors has a policy to pay dividends in proportion to earnings.

P2.20.

a.

SHAE, INC.
Income Statement
For the Year Ended December 31, 2016

Sales	$900,000
Cost of goods sold	(540,000)
Gross profit	$360,000
Selling, general, and administrative expenses	(72,000)
Earnings from operations (operating income)	$288,000
Interest expense	(48,000)
Earnings before taxes	$240,000
Income tax expense	(84,000)
Net income	$156,000

SHAE, INC.
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 2016

Paid-in capital:		
Common stock		$ 210,000
Retained earnings:		
Beginning balance	$129,000	
Net income for the year	156,000	
Less: Dividends declared and paid during the year	(39,000)	
Ending balance		246,000
Total stockholders' equity		$456,000

P2.20. ***(continued)***

a.

SHAE, INC.
Balance Sheet
December 31, 2016

Assets:		
Cash	$192,000	
Accounts receivable	120,000	
Merchandise inventory	264,000	
Total current assets		$576,000
Buildings and equipment	504,000	
Less: Accumulated depreciation	(216,000)	288,000
Total assets		$864,000
Liabilities:		
Accounts payable	$ 90,000	
Accrued liabilities	18,000	
Notes payable (long term)	300,000	
Total liabilities		$408,000
Stockholders' Equity:		
Common stock	$210,000	
Retained earnings	246,000	
Total stockholders' equity		$456,000
Total liabilities and stockholders' equity		$864,000

b. $84,000 income tax expense / $240,000 earnings before taxes = **35% average tax rate.**

c. $48,000 interest expense / $300,000 notes payable (long-term) = **16% interest rate.** This assumes that the year-end balance of long-term debt is representative of the *average* long-term debt account balance throughout the year. If large amounts of cash had been borrowed near the end of the year, then the interest rate charged on long-term debt would be greater than 16% because the average debt outstanding would have been less than $300,000. Likewise, if large repayments of long-term debt had occurred near year-end, then the interest rate was less than 16% because the average outstanding long-term debt would have been greater than $300,000.

d. $210,000 common stock / 42,000 shares = **$5 per share par value.**

e. $39,000 dividends declared and paid / $156,000 net income = **25%.** This assumes that the board of directors has a policy to pay dividends in proportion to earnings.

P2.21.

		Assets =	Liabilities +	Stockholders' Equity
a.	Borrowed cash on a bank loan	+	+	NE
b.	Paid an account payable	-	-	NE
c.	Sold common stock	+	NE	+
d.	Purchased merchandise inventory on account	+	+	NE
e.	Declared and paid dividends	-	NE	-
f.	Collected an account receivable	NE	NE	NE
g.	Sold inventory on account at a profit	+	NE	+
h.	Paid operating expenses in cash	-	NE	-
i.	Repaid principal and interest on a bank loan	-	-	-

P2.22.

a.

	Assets =	*Liabilities* +	*Stockholder's Equity*
August 1, 2016 totals	**$700,000**	**$550,000**	**$150,000**
August 3, borrowed $24,000 in cash from the bank	+ 24,000	+ 24,000	0
New totals	$724,000	$574,000	$150,000
August 7, bought merchandise inventory valued at $39,000 on account	+38,000	+38,000	0
New totals	$762,000	$612,000	$150,000
August 10, paid $14,000 cash operating expenses	–14,000	0	–14,000
New totals	$748,000	$612,000	$136,000
August 14, received $100,000 in cash from *sales*	+100,000		+100,000
of merchandise that had *cost* $66,000	–66,000	0	– 66,000
New totals	$782,000	$612,000	$170,000
August 17, paid $28,000 owed on accounts payable	–28,000	–28,000	0
New totals	$754,000	$584,000	$170,000
August 21, collected $34,000 of accounts receivable	0	0	0
New totals	$754,000	$584,000	$170,000
August 24, repaid $20,000 to the bank, plus $400 interest	–20,400	–20,000	–400
New totals	$733,600	$564,000	$169,600
August 29, paid Stacy-Ann Kelly a $10,000 cash dividend	– 10,000	0	–10,000
August 31, 2016 totals	**$723,600** =	**$564,000** +	**$159,600**

b. Total revenues were $100,000 (from sales) and total expenses were $80,400 (which included $14,000 of operating expenses, $66,000 of cost of goods sold, and $400 of interest expense). Thus, net income was $19,600 ($100,000 - $80,400).

Alternative calculation: Stockholder's equity increased by $9,600 during the month of August *(see answer to part c)*, even though a $10,000 cash dividend was declared and paid to Stacy-Ann Kelly. Since there were no capital stock transactions during the month, net income was $9,600. ($150,000 beginning stockholder's equity, plus $19,600 net income, minus $10,000 dividends, equals $159,600 ending stockholder's equity.)

c.

	August 1	*August 31*	*Net Change*
Total assets	$700,000	$723,600	$23,600
Total liabilities	550,000	564,000	14,000
Total stockholder's equity	150,000	159,600	9,600

P2.22. ***(continued)***

d. Stacy-Ann Kelly's stockholder's equity *increased* by $34,000 as a result of the sale on August 14th ($100,000 revenue - $66,000 cost of goods sold). Her stockholder's equity *decreased* by $14,000 for the operating expenses recorded on August 10th, by $400 for the interest expense recorded on August 24th, and by $10,000 for the cash dividend recorded on August 29th. In other words, her stockholder's equity was increased by revenues, and it was decreased by expenses and dividends.

e. Interest is an expense because it represents a necessary payment to *others* (i.e., creditors) for the use of their money—thus, it is a "cost" of doing business. Dividends are instead a distribution of profits to the owners/stockholders of the firm and thus represent a partial liquidation of the firm. A dividend is not an expense because it represents a profit distribution; it is not a "cost" of doing business.

f. When money is borrowed from the bank, an asset (cash) is increased and a liability (notes payable) is also increased by an equal amount. Net income is increased only when revenue has been earned—and money borrowed from the bank represents a liability that must be repaid, not revenue that has been earned.

g. Paying off accounts payable decreases an asset (cash) and decreases a liability (accounts payable) by an equal amount. Collecting an account receivable increases an asset (cash) and decreases another asset (accounts receivable) by equal amounts. *In both cases, only balance sheet accounts are involved*. Net income is increased by revenues and decreased by expenses. The expense associated with a cash payment of an account payable would have been recorded in an earlier transaction (when the expense was *incurred* and the account payable was established); by the same logic, the revenue associated with the collection of an account receivable would have been recorded in an earlier transaction (when the revenue was *earned* and the account receivable was established).

P2.23.

Amounts shown in the balance sheet below reflect the following use of the data given:

a. An asset should have a "probable future economic benefit"; therefore the accounts receivable are stated at the amount expected to be collected from customers.

b. Assets are reported at original cost, not current "worth." Depreciation in accounting reflects the spreading of the cost of an asset over its estimated useful life.

c. Assets are reported at original cost, not at an assessed or appraised value.

d. The amount of the note payable is calculated using the accounting equation, A = L + SE. Total assets can be determined based on items (a), (b), and (c); total stockholders' equity is known after considering item (e); and the note payable is the difference between total liabilities and the accounts payable.

e. The retained earnings account balance represents the difference between cumulative net income and cumulative dividends.

P2.23. ***(continued)***

Assets:			**Liabilities and Stockholders' Equity:**	
Cash		$ 3,500	Note payable	$ 12,000
Accounts receivable		17,000	Accounts payable	16,000
Land		55,000	Total liabilities	$ 28,000
Automobile	$90,000		Common stock	40,000
Less: Accumulated depreciation	(30,000)	60,000	Retained earnings	67,500
			Total stockholders' equity	107,500
Total assets		$135,500	Total liab.and stockholders' equity	$135,500

P2.24.

EPSICO, INC.
Balance Sheets
December 31, 2016 and 2015

Assets	***2016***	***2015***	**Liabilities**	***2016***	***2015***
Current assets:			Current liabilities:		
Cash	$ 228	$ 180	Note payable	$ 294	$ 240
Accounts receivable	756	720	Accounts payable	738	660
Inventory	1,446	1,380	Total current liabilities	$1,032	$ 900
Total current assets	$2,430	$2,280	Long-term debt	$ 360	$ 480
Land	$ 150	$ 150	**Stockholders' Equity**		
Equipment	2,340	2,250	Common stock	$1,200	$1,200
Less: Accum. depreciation	(1,080)	(960)	Retained earnings	1,248	1,140
Total land & equipment	$1,410	$1,440	Total stockholders' equity	$2,448	$2,340
Total assets	$3,840	$3,720	Total liabilities & stockholders' equity	$3,840	$3,720

Solution approach:

1. | | |
   |---|---|
   | Retained earnings, 12/31/15 | $1,140 |
   | Net income for 2016 (given) | 156 |
   | Dividends for 2016 (given) | (48) |
   | Retained earnings, 12/31/16 | $1,248 |

2. Cash at 12/31/16 is $48 more than at 12/31/15.

3. Cost of equipment at 12/31/16 is $90 more than the balance at 12/31/15.

4. Land balance at 12/31/16 is the same as at 12/31/15. Fair market value is irrelevant.

5. Calculate total current assets, total land and equipment, and total assets.

6. Total assets can then be used for total liabilities and stockholders' equity.

7. Total stockholders' equity is calculated and added to total current liabilities. This amount is subtracted from total liabilities and stockholders' equity to determine long-term debt.

P2.25.

	2014	**2013**
For the years ended November 30 and 24, respectively:		
Net revenues	$4,753,992	**$4,681,691**
Cost of goods sold	**2,405,552**	2,331,219
Gross profit	2,348,440	2,350,472
Selling, general and administrative expenses	**2,034,589***	1,884,965
Operating income	**313,851**	**465,507**
Interest expense and other expenses, net	159,997	142,894
Income before income taxes	153,854	**322,613**
Income tax expense	**49,545**	94,477
Net income	$ 104,309	$ 228,136

* Includes $128,425 of net restructuring charges, so 2014 selling, general and administrative expenses exclusive of these charges = $1,906,164 ($2,034,589 - $128,425). This is the amount most directly comparable to the S,G&A expenses shown for 2013 of $1,884,965.

As at November 30 and 24, respectively:		
Total assets	$2,924,073	**$3,127,418**
Total liabilities	2,691,954	2,913,918
Total stockholders' equity	**232,119**	213,500

P2.26.

a.

	2014	***2013***
Net sales	$182,795	$170,910
Cost of sales	(112,258)	(106,606)
Gross profit	**$ 70,537**	**$ 64,304**
Gross profit/net sales	**38.6%**	**37.6%**

Apple was able to achieve amazingly high sales growth rates for more than a decade since the introduction of the iPod in 2001, and in subsequent years with the introduction of the iPhone in 2007 and iPad in 2010. The company has now grown to a size and scale of operations where it has become difficult to maintain high sales growth rates on a percentage basis, although in absolute terms the nearly $12 billion increase in net sales from 2013 to 2014 is still a remarkable achievement.

Although the 1% increase in the gross profit/net sales ratio during the year ended September 27, 2014 was not terribly significant, it does represent a move in the right direction for the company. For your reference, here is Apple's 5-year trend for these data:

	2014	***2013***	***2012***	***2011***	***2010***
Net sales	$182,795	$170,910	$156,508	$108,249	$65,225
Cost of sales	(112,258)	(106,606)	(87,846)	(64,431)	(39,541)
Gross profit	$ 70,537	$ 64,304	$ 68,662	$ 43,818	$25,684
Gross profit/net sales	38.6%	37.6%	43.9%	40.5%	39.4%

b.

	2014	***2013***
Gross profit (from part *a* above)	$70,537	$64,304
Research and development expenses	6,041	4,475
Selling, general, and administrative expenses	11,993	10,830
Operating income	**$52,503**	**$48,999**
Operating income/net sales	**28.7%**	**28.7%**

There was no change in operating income as a percentage of net sales during the fiscal year ended on September 27, 2014, which reflects well on Apple's consistency of operations and predictability of earnings.

c.

	2014	***2013***
Operating income (from part *b* above)	$70,537	$64,304
Other income, net	**980**	1,156
Income before taxes	**$53,483**	**$50,155**
Provision for income taxes	(13,973)	**(13,118)**
Net income	$39,510	$37,037

Solution approach: The "Income before taxes" line has been added to emphasize the importance of understanding the difference between operating and non-operating items on the income statement. The problem could be solved without calculating this number.

C2.27.

In parts *a*, *b* and *d*, if students are willing to share the different kinds of assets, liabilities, revenues, expenses, and cash flows they have identified, this case can be used to review the basic characteristics of the balance sheet, income statement, and statement of cash flows.

In part *c*, the point is that *projected* income activity for the current period has a direct impact on the *projected* balance sheet.

In part *e*, the point is that income and cash flow are two different things entirely. Possible explanations might include:

- Receipt of student loan proceeds (or scholarships, grants) towards the end of the semester.

- Certain costs of attending college (i.e., tuition, room and board, meal plans) might be incurred by the student, but not yet paid.

- A student may be employed on a part-time (or full-time) basis throughout the semester, which may generate more cash flow than she was able to accumulate during the summer preceding the fall semester.

TAKE-HOME QUIZ —CHAPTER 2 **NAME**______________________

Presented below is the Statement of Cash Flows for Marstore, Inc., for the year ended December 31, 2016. Also shown is a partially completed comparative balance sheet as of December 31, 2016 and 2015.

MARSTORE, INC.
Statement of Cash Flows
For the Year Ended December 31, 2016

Cash flows from operating activities:		
Net Income	$ 23,000	
Add (deduct) items not affecting cash:		
Depreciation expense	6,000	
Decrease in accounts receivable	8,000	
Decrease in accounts payable	(6,000)	
Net cash provided by operating activities		$31,000
Cash flows from investing activities:		
Purchase of store fixtures		$(4,000)
Cash flows from financing activities:		
Repayment of long-term debt	$ (2,000)	
Payment of cash dividends on common stock	(5,000)	
Net cash used by financing activities		$(7,000)
Increase in cash for the year		$20,000

MARSTORE, INC.
Balance Sheets
December 31, 2016 and 2015

	2016	***2015***		***2016***	***2015***
Current assets:					
Cash	$ 37,000	$______	Accounts payable	$ ______	$18,000
Accounts receivable	______	39,000	Long-term debt	18,000	______
Total current assets	$______	$______	Total liabilities	$ ______	$______
Store fixtures	$______	$ 24,000	Common stock	$ ______	$ 20,000
Less: Accumulated depreciation	(13,000)	______	Retained earnings	______	______
			Total s'holders' equity	$ ______	______
Net store fixtures	$______	$______			
Total assets	$______	$______	Total liabilities and s'holders' equity	$ ______	$______

TAKE-HOME QUIZ —CHAPTER 2 *(continued)*

1. Complete the balance sheets for Marstore, Inc., at December 31, 2016 and 2015. Identify your strategy by listing, in general, the sequence of steps you used to find the unknown amounts.

2. Does the amount shown on the balance sheet for Net Store Fixtures represent the current fair market value of the store fixtures? Explain your answer.

3. Prepare a Statement of Changes in Retained Earnings for the year ended December 31, 2016.

TAKE-HOME QUIZ KEY—CHAPTER 2

1. • Use information in the statement of cash flows to determine either the beginning or ending amounts for assets and liabilities. For example, accounts receivable decreased $8,000, so at the end of 2016 the balance was $31,000.

   • Based on total assets and total liabilities at the beginning and end of the year, determine total stockholders' equity at each date.

   • Using total stockholders' equity at the end of 2015, solve for retained earnings at that date.

   • The cash flows from financing activities on the statement of cash flows does not show any cash from the sale of additional stock, so the ending balance is the same as the beginning balance. Knowing this, retained earnings at the end of the year can be determined.

   • Or, use information about net income and dividends from the statement of cash flows, and the beginning balance of retained earnings (as determined above) to calculate ending retained earnings. Then, capital stock at the end of the year can be determined.

MARSTORE, INC.
Balance Sheets
December 31, 2016 and 2015

	2016	***2015***		***2016***	***2015***
Current assets:					
Cash……………………	$37,000	$17,000	Accounts payable……..	$12,000	$18,000
Accounts receivable……	31,000	39,000	Long-term debt……….	18,000	20,000
Total current assets….	$68,000	$56,000	Total liabilities………..	$30,000	$38,000
Store fixtures…………..	$28,000	$24,000	Common stock………..	$20,000	$20,000
Less: Accumulated depreciation…………	(13,000)	(7,000)	Retained earnings…….	33,000	15,000
			Total s'holders' equity..	$53,000	$35,000
Net store fixtures………	$15,000	$17,000			
Total assets…………….	$83,000	$73,000	Total liabilities and s'holders' equity…...	$83,000	$73,000

2. No. The balance sheet shows the original cost of assets, less accumulated depreciation, which for accounting purposes is that portion of the cost of the asset that has been "used up."

3.

Retained earnings, 12/31/15..	$15,000
Add: Net income for the year..	23,000
Less: Dividends declared and paid	(5,000)
Retained earnings, 12/31/16..	$33,000

ACCOUNTING

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Accounting
What the Numbers Mean

CHAPTER 2: *Financial Statements and Accounting Concepts/Principles*

Marshall, McManus, and Viele

11th Edition

Learning Objectives

After studying this chapter you should understand and be able to:

LO 2-1: Explain what transactions are.

LO 2-2: Identify and explain the kind of information reported in each financial statement and describe how financial statements are related to each other.

LO 2-3: Explain the meaning and usefulness of the accounting equation.

LO 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

LO 2-5: Identify and explain the broad, generally accepted concepts and principles that apply to the accounting process.

LO 2-6: Discuss why investors must carefully consider cash flow information in conjunction with accrual accounting results.

LO 2-7: Identify and explain several limitations of financial statements.

LO 2-8: Describe what a corporation's annual report is and why it is issued.

Financial Statements

Transactions are economic interchanges between entities that are accounted for and reflected in financial statements.



Learning Objective 2-1: Explain what transactions are.

Financial Statements

Transactions

- Procedures for sorting, classifying, and presenting (bookkeeping)
- Selection of alternative methods of reflecting the effects of certain transactions (accounting)

Financial Statements

An entity's financial statements are the end product of a process that starts with transactions between the entity and other organizations and individuals.

Learning Objective 2-1: Explain what transactions are.

Accounts

Transactions are summarized in accounts.

Accounts are used to organize like-kind transactions.

Account balances are then used in the preparation of financial statements.

Learning Objective 2-1: Explain what transactions are.

Financial Statements

Required Disclosure	Financial Statement that Satisfies Requirement
Financial position at the end of the period	Balance Sheet
Earnings for the period	Income Statement
Cash flows during the period	Statement of Cash Flows
Investments by and distributions to owners during the period	Statement of Changes in Owners' Equity

In addition to the financial statements, the annual report will probably include several accompanying notes or explanations of the accounting policies used and detailed information about many of the amounts and captions shown in the financial statements.

Learning Objective 2-2: Identify and explain the kind of information reported in each financial statement and describe how financial statements are related to each other.

Balance Sheet—Elements

Assets **represent the amount of resources owned by the entity.**

Liabilities **are amounts owed to other entities.**

Equity **is the ownership right of the owner(s) of the entity in the assets that remain after deducting the liabilities.**

MAIN STREET STORE, INC.
Balance Sheet
August 31, 2017

Assets		Liabilities and Stockholders' Equity	
Current assets:		Current liabilities:	
Cash	$ 34,000	Accounts payable	$ 35,000
Accounts receivable	80,000	Other accrued liabilities	12,000
Merchandise inventory	170,000	Short-term debt	20,000
Total current assets	$284,000	Total current liabilities	$ 67,000
Plant and equipment:		Long-term debt	50,000
Equipment	40,000	Total liabilities	$117,000
Less: Accumulated depreciation	(4,000)	Stockholders' equity	203,000
Total assets	$320,000	Total liabilities and stockholders' equity	$320,000

Learning Objective 2-3: Explain the meaning and usefulness of the accounting equation.

Balance Sheet

Presents the balances in an entity's accounts at a given point in time

Assets = Liabilities + Equity

MAIN STREET STORE, INC.
Balance Sheet
August 31, 2017

Assets		Liabilities and Stockholders' Equity	
Current assets:		Current liabilities:	
Cash	$ 34,000	Accounts payable	$ 35,000
Accounts receivable	80,000	Other accrued liabilities	12,000
Merchandise inventory	170,000	Short-term debt	20,000
Total current assets	$284,000	Total current liabilities	$ 67,000
Plant and equipment:		Long-term debt	50,000
Equipment	40,000	Total liabilities	$117,000
Less: Accumulated depreciation	(4,000)	Stockholders' equity	203,000
Total assets	$320,000	Total liabilities and stockholders' equity	$320,000

Learning Objective 2-3: Explain the meaning and usefulness of the accounting equation.

Balance Sheet

Current assets are those assets that are likely to be converted into cash or used to benefit the entity within one year.

MAIN STREET STORE, INC.
Balance Sheet
August 31, 2017

Assets		Liabilities and Stockholders' Equity	
Current assets:		Current liabilities:	
Cash	$ 34,000	Accounts payable	$ 35,000
Accounts receivable	80,000	Other accrued liabilities	12,000
Merchandise inventory	170,000	Short-term debt	20,000
Total current assets	$284,000	Total current liabilities	$ 67,000
Plant and equipment:		Long-term debt	50,000
Equipment	40,000	Total liabilities	$117,000
Less: Accumulated depreciation	(4,000)	Stockholders' equity	203,000
Total assets	$320,000	Total liabilities and stockholders' equity	$320,000

Plant and equipment includes long-term assets that will benefit the entity over several years.

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Balance Sheet

Long-term liabilities are those liabilities that will not be repaid within one year of the balance sheet date.

MAIN STREET STORE, INC.
Balance Sheet
August 31, 2017

Assets		Liabilities and Stockholders' Equity	
Current assets:		Current liabilities:	
Cash	$ 34,000	Accounts payable	$ 35,000
Accounts receivable	80,000	Other accrued liabilities	12,000
Merchandise inventory	170,000	Short-term debt	20,000
Total current assets	$284,000	Total current liabilities	$ 67,000
Plant and equipment:		Long-term debt	50,000
Equipment	40,000	Total liabilities	$117,000
Less: Accumulated depreciation	(4,000)	Stockholders' equity	203,000
Total assets	$320,000	Total liabilities and stockholders' equity	$320,000

Current liabilities are those liabilities that are to be paid within one year.

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Income Statement

The income statement shows the net income (or net loss) for the period of time under consideration.

Revenues result from the entity's operating activities (e.g., selling merchandise).

Costs and expenses are incurred in generating revenues and operating the entity.

Notice that the statement starts with **net sales** and that the various expenses are subtracted to arrive at **net income**

MAIN STREET STORE, INC.
Income Statement
For the Year Ended August 31, 2017

Net sales	$1,200,000
Cost of goods sold	850,000
Gross profit	$ 350,000
Selling, general, and administrative expenses	311,000
Income from operations	$ 39,000
Interest expense	9,000
Income before taxes	$ 30,000
Income taxes	12,000
Net income	$ 18,000
Earnings per share of common stock outstanding	$ 1.80

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Income Statement

Income taxes are shown after all the other income statement items have been reported.

Earnings per share of common stock outstanding is reported as a separate item at the bottom of the income statement because of its significance in evaluating the market value of a share of common stock.

MAIN STREET STORE, INC.
Income Statement
For the Year Ended August 31, 2017

Net sales	$1,200,000
Cost of goods sold	850,000
Gross profit	$ 350,000
Selling, general, and administrative expenses	311,000
Income from operations	$ 39,000
Interest expense	9,000
Income before taxes	$ 30,000
Income taxes	12,000
Net income	$ 18,000
Earnings per share of common stock outstanding	$ 1.80

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Statement of Changes in Stockholders' Equity

MAIN STREET STORE, INC. Statement of Changes in Stockholders' Equity For the Year Ended August 31, 2017	
Paid-In Capital:	
Beginning balance	$ –0–
1.Common stock, par value, $10; 50,000 shares authorized, 10,000 shares issued and outstanding	100,000
Additional paid-in capital	90,000
Balance, August 31, 2017	$190,000
Retained Earnings:	
Beginning balance	$ –0–
Net income for the year	18,000
Less: Cash dividends of $.50 per share	(5,000)
Balance, August 31, 2017	$ 13,000
Total stockholders' equity	$203,000

This financial statement shows the detail of stockholders' equity and explains the changes that occurred in the components of stockholders' equity during the year.

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

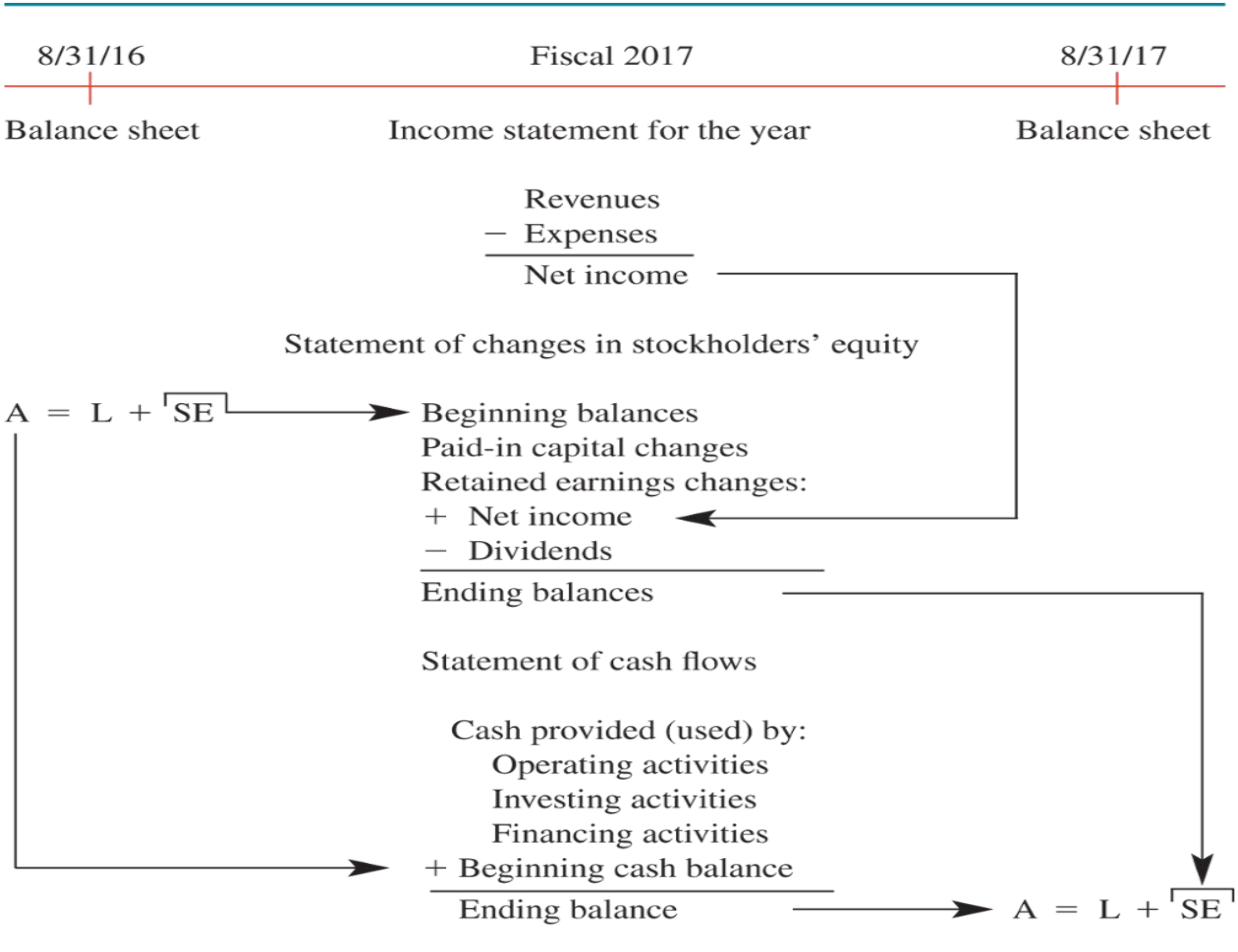
Statement of Cash Flows

The purpose of this financial statement is to identify the sources and uses of cash during the year.

MAIN STREET STORE, INC. Statement of Cash Flows For the Year Ended August 31, 2017	
Cash Flows from Operating Activities:	
Net income	$ 18,000
Add (deduct) items not affecting cash:	
Depreciation expense	4,000
Increase in accounts receivable	(80,000)
Increase in merchandise inventory	(170,000)
Increase in current liabilities	67,000
Net cash used by operating activities	$(161,000)
Cash Flows from Investing Activities:	
Cash paid for equipment	$ (40,000)
Cash Flows from Financing Activities:	
Cash received from issue of long-term debt	$ 50,000
Cash received from sale of common stock	190,000
Payment of cash dividend on common stock	(5,000)
Net cash provided by financing activities	$ 235,000
Net increase in cash for the year	$ 34,000

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Time-Line Model



Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Financial Statement Relationships

Balance sheet	Income Statement
Assets = Liabilities + Stockholders' equity	← Net Income = Revenues − Expenses

The arrow indicates that net income affects retained earnings, which is a component of stockholders' equity.

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Financial Statement Relationships

8/31/16 — Fiscal 2017 — 8/31/17

MAIN STREET STORE, INC.
Statement of Cash Flows
For the Year Ended
August 31, 2017

Cash provided (used) by:	
Operating activities	$(161,000)
Investing activities	(40,000)
Financing activities	235,000
Net change in cash	$ 34,000

MAIN STREET STORE, INC.
Balance Sheet
At August 31, 2016

Assets	
Cash	$ —
All other assets	—
Total assets	$ —
Liabilities and stockholders' equity	
Liabilities	$ —
Stockholders' equity:	
Paid-in capital	$ —
Retained earnings	—
Total stockholders' equity	$ —
Total liabilities and stockholders' equity	$ —

MAIN STREET STORE, INC.
Income Statement
For the Year Ended
August 31, 2017

Revenues	$ 1,200,000
Expenses	(1,182,000)
Net income	$ 18,000

MAIN STREET STORE, INC.
Statement of Changes in
Stockholders' Equity
For the Year Ended
August 31, 2017

Paid-in capital from sale of stock		$ 190,000
Retained earnings:		
Beginning balance	$ 0	
+ Net income	18,000	
− Dividends	(5,000)	
Ending balance		$ 13,000
Total change in stockholders' equity		$ 203,000

MAIN STREET STORE, INC.
Balance Sheet
At August 31, 2017

Assets	
Cash	$ 34,000
All other assets	286,000
Total assets	$ 320,000
Liabilities and Stockholders' Equity	
Liabilities	$ 117,000
Stockholders' equity:	
Paid-in capital	$ 190,000
Retained earnings	13,000
Total stockholders' equity	$ 203,000
Total liabilities and stockholders' equity	$ 320,000

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Financial Statement Relationships

If assets equal $300,000 and liabilities equal $125,000, what is stockholders' equity?

Balance Sheet				
Assets	=	Liabilities	+	Stockholders' Equity
320,000	=	117,000	+	?

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Financial Statement Relationships

If assets equal $320,000 and liabilities equal $117,000, what is stockholders' equity?

Balance Sheet				
Assets	=	Liabilities	+	Stockholders' Equity
320,000	=	117,000	+	203,000

Stockholders' equity equals $203,000

($320,000 - $117,000)

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Financial Statement Relationships

Now, suppose that total assets increase $10,000 during the year and total liabilities decrease $3,000 during the year.

Balance Sheet				
Assets	=	Liabilities	+	Stockholders' Equity
320,000		117,000		203,000
10,000		(3,000)		?
330,000		114,000		?

What is stockholders' equity at the end of the year?

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Financial Statement Relationships

Stockholders' equity must have increased by $13,000. Since stockholders' equity was $203,000 at the beginning of the year, it must be $216,000 at the end of the year.

Balance Sheet				
Assets	=	Liabilities	+	Stockholders' Equity
320,000		117,000		203,000
10,000		(3,000)		13,000
330,000		114,000		216,000

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Balance Sheet

Account	Definition
Cash	Cash on hand and in the bank
Accounts receivable	Amounts due from customers
Merchandise inventory	Cost of merchandise acquired and not yet sold
Equipment	Cost of equipment purchased and used in business
Accumulated depreciation	Portion of the cost of equipment that is estimated to have been used up in the process of operating the business
Short-term debt	Amounts borrowed that will be repaid within one year of the balance sheet date
Accounts payable	Amounts due to suppliers
Other accrued liabilities	Amounts owed to various creditors
Long-term debt	Amounts borrowed from banks or other creditors that will not be repaid within one year from the balance sheet date
Stockholders' equity	Residual claim of owners, computed as "assets minus liabilities"

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Income Statement

Captions	Explanation
Net sales	Amount of sales of merchandise to customers, less the amount of customer returns of merchandise
Cost of goods sold	Represents the total cost of merchandise removed from inventory and delivered to customers as a result of sales
Gross profit	Difference between net sales and cost of goods sold; Represents the seller's maximum amount of "cushion" from which all other expenses of the business must be deducted before it is possible to have net income
Selling, general, and administrative expenses	Represents the operating expenses of the entity
Income from operations	Represents one of the most important measures of the firm's activities
Interest expense	Represents the cost of using borrowed funds
Income taxes	Shown after all of the other income statement items have been reported because income taxes are a function of the firm's income before taxes
Net income per share of common stock outstanding	A significant item in evaluating the market value of a share of common stock; Often referred to as "earnings per share" or EPS

Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Statement of Changes in Stockholders' Equity

Captions	Explanation
Paid-in capital	Represents the total amount invested in the entity by the owners
Common stock	Reflects the number of shares authorized by the corporation's charter, the number of shares issued to stockholders, and the number of shares still held by the stockholders
Additional paid-in capital	Difference between the total amount invested by the owners and the par value or stated value of the stock
Retained earnings	Represents the cumulative net income of the entity that has been retained for use in the business
Dividends	Distributions of earnings to the owners

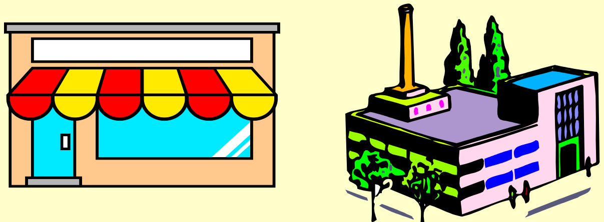
Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Statement of Cash Flows

Captions	Explanation
Cash flows from operating activities	Shown first; Net income is the starting point for this measure of cash generation
Depreciation expense	Added back to net income because it is subtracted to arrive at net income, but does not require the use of cash
Increase in accounts receivable	Deducted because it reflects sales revenues, included in net income, but not yet received in cash
Increase in merchandise inventory	Deducted because cash was spent to acquire the increase in inventory
Increase in current liabilities	Added because cash has not yet been paid for the products and services that have been received during the current fiscal period
Cash flows from investing activities	Shows the cash sources and uses related to long-lived assets
Cash flows from financing activities	Shows the cash sources and uses related to transactions with creditors and stockholders

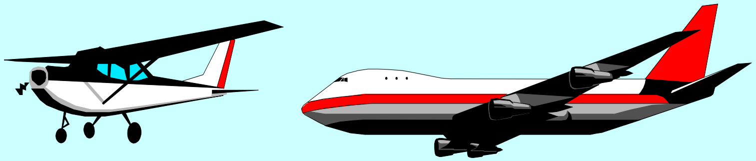
Learning Objective 2-4: Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Accounting Concepts and Principles



Accounting Entity

Every economic entity can be separately identified and accounted for.



Now Future

Going Concern Concept

The presumption that the entity will continue to operate in the future—it's not being liquidated.

Unit of Measurement

Only transactions denominated in dollars (currency) are recorded in the accounting records.

Cost Principle

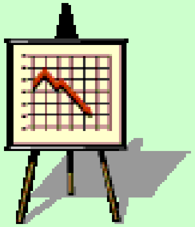
Transactions are recorded at their original cost to the entity as measured in dollars.

Learning Objective 2-5: Identify and explain the broad, generally accepted concepts and principles that apply to the accounting process.

Accounting Concepts and Principles

Objectivity

The accountants' desire to have a given transaction recorded in the same way in all situations.



Accounting Period

The period of time selected for reporting results of operations and changes in financial position.

Matching Concept

All expenses incurred to generate that period's revenues be deducted from the revenues earned.

Accrual Accounting

Recognize revenue at the point of sale and recognize expenses when incurred, even though the cash receipt or payment may occur at another time.

Learning Objective 2-5: Identify and explain the broad, generally accepted concepts and principles that apply to the accounting process.

Accounting Concepts and Principles

Consistency

Provides meaningful trend comparisons over several years.

Full Disclosure

Circumstances and events that make a difference to financial statement users should be disclosed.

Materiality

The benefit of increased accuracy should outweigh the cost of achieving the increased accuracy.

Conservatism

When in doubt, make judgments and estimates that result in lower profits and asset valuations.

Learning Objective 2-5: Identify and explain the broad, generally accepted concepts and principles that apply to the accounting process.

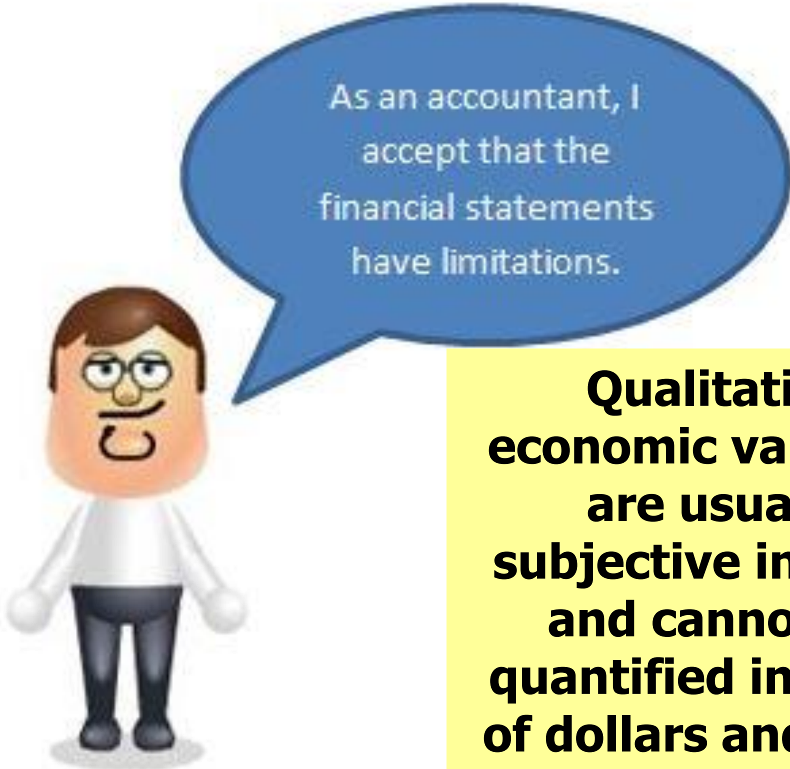
Accrual Accounting Vs. Cash Flows

Revenue Recognition -*Timing* is the Key

Accrual accounting recognizes:	***Cash flow*** recognizes:
Revenue *when revenue is earned,* at the point of sale of services or products.	Revenue *when payment is received* for services rendered or products sold.
Expenses *when they are incurred.*	Expenses *when they are paid.*

Learning Objective 2-6: Describe why investors must carefully consider cash flow information in conjunction with accrual accounting results.

Limitations of Financial Statements



Qualitative economic variables are usually subjective in value and cannot be quantified in terms of dollars and cents that can be verified.

Financial statements report only <u>quantitative</u> economic data.

They do <u>not</u> reflect <u>qualitative</u> economic variables, such as the value of the management team or the employees' morale.

How do the terms "quantitative" and "qualitative" differ?

Learning Objective 2-7: Identify and describe several limitations of financial statements.

Limitations of Financial Statements

<u>Historical Cost Concept</u>

Assets are usually valued at the cost of the Asset when acquired.

The balance sheet does <u>not</u> report market values or replacement cost of the assets.

<u>Matching Concept</u>

Estimates are acceptable provided there is a basis for them.

Many estimates are used, such as warranty costs, depreciation, and pension expense.

Learning Objective 2-7: Identify and describe several limitations of financial statements.

The Corporation's Annual Report

The annual report is distributed to shareholders (and others).

It contains the financial statements, together with the report of the external auditor's examination of the financial statements.

It also contains Management's Discussion and Analysis (MD&A).

Learning Objective 2-8: Describe what a corporation's annual report is and why it is issued.

End of Chapter 2